A DIAGONOSIS OF THE BRITISH MONETARY CRISIS, CONTRIBUTING TO THE WILSON COMMITTEE

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The British economy was attacked with the worst monetary crisis in 1970's. The City seemed to be blessed with a financial boom in '73, but in time it plunged in to panic and suffered from severe stag-flation until the end of '76. The Wilson Committee whic was set up to review the functioning of the financial Institutions in Jannualy 1977 had been expected not only to make just inquiries about the monetary crisis, but to propose an appropriete financial reform for industry.

However, according to many evidences submitted to the Committee, it could not help to be claimed that they had been too much indulgent and permissive in their behavior. The Bank's Memorundum (Saving and Investment, recent developments in financial arrangements), which might be one of the important reports as a representative view of the city, insisted that a fundamental reason of economic crisis was unprecedentedly rapid inflation combined with high nominal interest rates, decreasing real profitability in the domestic industries: In particular, the Authorities have been concerned about a serious impact of inflationary expectations on the business finance. Therefore they have enlarged their refinance facility of ECGD and participated in establishing the FFI or the ECI.

According to its view, the private financial Institution played efficient role to channel saving into industry and trade, though their performance (after-care) was not good. So that, there were some financial gaps between business sector and institutional investors whose share of saving fund has increased recently. The paper touched on this respect with such a sophiscated representation as follows.

"The Bank, while recognizing the force of some of the arguments deployed in defence of the *arm's length* relationship and in particular accepting that it is no easy matter for the financial sector to identify and procure the solution of industrial problems came to the conclusion that some change was needed and are not disappointed with the progress that has been made so far"[1].

More over, the Bank submitted recently a Memorundum entitled "the Secondary Banking Crisis and the Bank's Support Operation" which made much clear a motive of the 74 year's panic and their rescue operation. It emphasized that an important motive of panic was very imprudent financial speculation of the deposit-taking institutions, such as the London and County Securities. "In the circustances of the closing weeks of 1973, therefore, the Bank felt it essential to meét their responsibility for fully-recognized banks by mounting a rescure operation for the benefit of the depositors of a group of Institution which were not fully-recognized bank, but whose otherwise inevitable collapse would have threatened the well-being of some recognized banks"[2]. Therefore, the Bank is now taking steps to tighten its supervision, not only over the primary banks, but also the secondary or fringe banks. This public supervision is said, however, to be conducted flexibly, privately and participatedly and then, legal or administrative measures would be, if possible, avoided, unlike the other EC countries (evidence by Governnor Richardson). It could be supposed that the Bank's supervision might be at times exercised as a supplement to monetary policy.

All the other evidences except one of the TUC demonstrated that the British stag-flation was not due to a short coming of the financial institutions. They often stressed lender's willingness to lend and company's unwillingness to borrow that had nothing to do with the City. However, there remain to be these problems which should be resolved by the Committee.

(1) One of the distinguishing feature of the 1970's is the enormous devepment of the consortiumbanks and the multi national conglomerat enterprises. This was beneficial to the U.K. in that

the London City could seize this opportunity in order to *rise again to* the status of the international financial centre and to earn huge amounts of invisible earning. However, the internationalization of the London financial market may have constrained the policy-makers in their choice of the appropriete domestic macro-policy measures. MR. S. Holland made a sharp critisism in this respect: the conglo-merates have an adverse effect on the fiscal and monetary policy through their transfer pricing and financial operation. The U.K. consortium banks may have taken a lion's share of those extra-profits. But they would undermine the exchange control and erode the monetary measures. "The increasing multinationalization of the European Capital market through these channels seriously undermines the effectiveness of Government monetary policy as an instrument of restricting the availability of credit. Since these markets are telephone or telex markets and involve only invisibles rather than direct investment and plant, they can operate very much like the perfectly mobile capital market of text book theory. … The Bank has encouraged short term capital flows despite their counter-productive effects in increasing domestic liquidity when government policy is concerned to restrain it so far as to prevent a further deterioriation in the balance of payments"[3]. The evidence by representatives of the financial circles are unanimous in that they condemn the volatility of policy stance and the uncertainty of market expectations. But one have to suspect that the volatility and the uncertainty may have arisen from above-mentioned circumstances.

(2) On the reasons of the British Stag-flation. There have recently been two note worthy articles (Miss Downton in BOE, QB, and MR. Reid in Economic Trends) which pointed out that the size of the public debt held by the private sector is at its lowest level in the post-war period both in real term and in relation to the GDP (table I. II). It is even asserted that this reduction in the public debt is a deflationary factor through the real balance effect. More over, the treasury memorandum described the stag-flation by crowing out to be a financial phenomenon. "In the sort of disequibrium situation the U.K. has been facing in recent years, the current account is it self an indication that domestic saving has

been insufficient to much investment. It is, however, doubtfull whether the level of public sector expenditure and the size of the PSBR over the last three years have in fact made much difference on balance to the flow of funds to private industry or inhibited investment. On the one hand, the higher public expenditure and lower taxation possible within a higher PSBR can help to sustain activity and foster investment (new Cambridge school assumption). On the other hand, the need to finance that PSBR can effect confidence and expectation, particularly in financial market in way which tend to curtail activity and investment. … It is, however, true that there was some apparent crowding out last year in the sense that the public sector forced up the price of capital against industry. The high present and prospective levels of the PSBR were one of the factors causing the collapse in finacial market from March onwards leading to high interest rates in the way described above and to the equity market becoming too expensive for companies to be prepared to raise capital on it."[4]
Indeed, the financial statistics demonstrate that the expansion of M_3 and DCE in the first half of 1976 was mainly due to the increase in bank lending to the company sector rather than to the increse in the banking sector's holding of the public debt (table VI, IX). But it should be worth notice that these facts do not exonerate the fiscal policy in 1975 from having been the ultimate cause of the inflation. Surely, the spending and capital formation by the public sector amounted to no more than £ 27 ^{b}(29% of GDP), but the total expenditures including transfering and financial spending amounted to £ 51 ^{b}(55% of GDP) – table V. This enormous expenditure entailed the PSBR of £ 10.8 ^{b} and the nominal amount of the public debt at the end of 1975 was pushed up to £ 73.9 ^{b} from £ 61.6 ^{b} in 74 year. – table. It was the highest level ever attained. As a consequence, TB and other short-term debt (e.g. local authorities bill) increased markedly in the latter half of 1975. In an effort to fund these floating debts, the authorities issued a big amount of high coupon (gilt-edged securities) and purchased the floating debt by open back door system. This would widened the long-short interest rate spread which in turn caused arbitrage transactions to increase in the latter half of 1976. The money

needed for these transactions just has to make trips in the financial circuit, giving rise to asset inflation, but without any incentive to productive investment. Precisely the same thing had happened in the summer of 1973. But the Bank's Memorandums seems to underestimate the fact that the clearing bank's credit creation backed up by the authorities at that times was the basic factor of the asset inflation.

(3) The British Monetary Crisis in the summer of 1976 should be not only the result of a failure in credit control, but the defects of the C & CC system. The sterling balance started already to drain in the spring, worried about floating down of the sterling and then the Bank supported it by official financing. However, their monetary sqweeze was too delayed to check the expansion of the DCE and M_3. On these aspect, the financial review of BOE, QB (June, 1976) pointed out that "The Bank gave assistance when necessary by purchasing treasury bills and Local authority bills and on nine occasions by lending over-night at minimum lending rate, ··· the average rate of discount at the tender initially continued to decline, dropping sharply on 6th Febrary to nearly 8¾% and bringing the Bank's minimum lending rate down to 9½%."[5] They have recognized this reduction of the interest rates as rather precipitate. Mr. S. Brittan made a following remark in this respect. "The high DCE may itself be due to people who fear inflation and depreciation borrowing from the banks to purchase imports or non sterting-assets. ··· Although, DCE can be curbed by raising internal interest rates and reducing money supply through the funding operation, they moved so reluctantly and slowly towards monetary control and only under pressure from the foreign exchanges and IMF."[6] It should be in relation to a behavior of the discout houses. They have changed up their investment practice by 1975 That is to say, a shortning of books and emphasis on trading. Many of them were dealing on an in and out basis with 24 hours.[7] However, they were able to get special support of the Bank through MLR (over night money or purchasing operation of TB. Mr. P. J. Lee just criticized the MLR system. "This problem of indicating a proper level for short term interest rates would be less if it were not for the MLR formula substituted

for Bank rate in 1972. … The New formula appears to put the onus of changing the rate on the discount market and yet does not do so entirely. There are likely to be occations when the houses find themselves inhibited from bidding even an extra penny for TB in case MLR should fall and undue significance be attributed to it.[8] He asked these problem to be solved in the committee, but it is said at present that the MLR is abrogated by the Bank rate.

Following to some Monetarists in this country, those failures have to be based on defects of the C & CC, in other words, the new reserve ratio system:
The eligible reserve assets are not the high powered money (cash base) to be controlled by the Bank. They have to be the multiple assets (call loan, TB and other short public debt). Their fluctnation are very elastic in response to financial transaction between the banking sector and others, opposed to the West Germany or U.S.A. whose main reserve assets have to be the cash reserve (Banker's deposit). We must agree with professor B. Griffiths's opnion in this point. He stressed on "The reason for the confusion is that a convention has grown up over the years by which the Bank has used the rediscounting and lending facilities which are critical to its operations as a lender of last resort as an alternative to conducting open market operations via net sales of gilt-edged stock."[9] That is to say, the Bank awkwardly has made control of the money supply difficult by being prepared to stand ready and exchange cash for bills virtually on demand. These control system surely was thought to have led excessive bank lending. It was alleged by the committee of London clearing banker that clearer's lending to property companys was negligible as afore said. But it was estimated that their lending in charge of property would amount to so enamously that they should be the main principals of financial boom themselves. Mr. D. F. Channon, in his British Banking Strategy, affirmed: "It certainly is unfair to place all the blame for the crash upon imprudent management by the secondary banks themselves. While some element of this was clearly present in thier over-extension to the property sector, the secondary banks were so attempting to exploit corners of the market, that other financial institutions had left vacant. Moreover, their

entrepreneurial approach was actively condoned and supported by the clearing banks and other first-line financial operators."[10] And then he dared to condemn the Bank in that it could not to have an insight into the implication of a loose monetary policy and a weakness in the C & CC. In place of my conclusion, I would quote a passage from King's History of the London Discount Market. "But not even the Bank's better appreciation of its responsibilities, the opening of Bank Branches, the Growth of joint-stock banking and the new reserve policy of the London bankers – the four great changes (in 1830s) which were to have made impossible a reptition of the disaster of 1825 – were able to prevent the germination of the seeds of a new crises. Indeed, by the very fact they stimulated the expansion of the bill market, these changes were the indirect of a new source of trouble – an unduly reckless use of the extraordinary facilities for rediscounting in London. Actually, the fault lay not in the new mechanism, but in the manner in which it was utilized. ··· In a sense, ultimate responsibility lay with the Bank, for permitting, if not fostering, an easy credit position which favoured the growth of doubtful paper."[11]

1) BOE, QB, Sept. 1977, p. 317.
2) BOE, QB, June, 1978, p. 233.
3) S. Holland, The Socialist Challange, p. 82.
4) Evidence on the financing of Industry and Trade, Vol. I; pp. 52–53.
5) BOE, QB, June, 1976, p. 169.
6) FT. Sept. 16. 1976.
7) J. S. G. Wilson, London Money Market, p. 19.
8) P. J. Lee, Diagnosis, not Dogma, the Banker, Febrary. 1977, p. 89.
9) B. Griffiths, How the Bank has mismanaged Monetary policy, The Banker, Dec. 1976. p. 1417.
10) D. F. Channon, British Banking strategy, p. 105.
11) W. King. History of the London Discount Market, pp. 91–92.

Table I. Nominal outstanding of the public debt

£ million each end of the year

	1970	1971	1972	1973	1974	1975	1976
Government	34,076	34,617	37,490	37,764	39,520	45,504	55,484
Local Authorities	14,546	15,876	17,173	18,757	21,252	24,328	26,988
Public Coporations	11,194	12,272	13,003	13,721	15,284	17,519	20,763
Net total of outside holding	42,996	44,313	47,544	48,514	52,780	61,652	73,983
Percentage of total debt that is held outside public sector	71.9%	70.6%	70.3%	69.1%	69.4%	70.6%	72.2%
Public debt held outside as a percentage of GNP	97.6%	89.4%	85.7%	74.9%	70.5%	65.5%	68.0%

(C.S.O. Economic Trends, 5. 1977)

Table II. Market holding of the national debt

£ million each end of the year

	1970	1971	1972	1973	1974	1975	1976
Current prices	23,424	23,640	26,619	26,343	29,719	31,710	40,407
As percentage of GDP	58.3%	53.0%	52.6%	45.9%	43.1%	40.3%	41.5%
At 1970 prices	24,946	23,109	23,515	21,227	20,470	19,514	19,711
Market value in market hands	19,538	19,824	23,561	21,441	19,761	25,031	33,315
As percentage of GDP	48.6%	44.5%	46.5%	37.4%	32.8%	31.8%	34.2%
At 1970 prices	20,807	19,378	20,814	17,277	14,595	15,404	16,251

(BOE, QB, 9. 1977)

Table III. PSBR and its service cost

£ million each end of the year

	1970	1971	1972	1973	1974	1975	1976
PSBR	18	1,371	2,038	4,168	6,336	10,515	9,512
Service of national debt	1,458	1,580	1,793	2,192	2,699	3,323	4,266
Service of Local debt	1,064	1,104	1,170	1,489	2,057	2,416	2,894
Net total	2,145	2,213	2,422	2,904	3,767	4,438	5,736
Public Expenditure	11,166	12,516	14,034	16,447	20,423	27,161	31,163
Public debt service as a percentage of public expenditure	18.9%	17.6%	17.1%	17.6%	18.1%	16.2%	18.3%

(CSO, FS & Abstract)

Table IV. Net acquisition of financial assets and PSBR

£ million, each year

		1970	1971	1972	1973	1974	1975	1976
Government		△2,798	△1,941	△505	△178	522	2,633	4,258
Local Authorities		1,255	1,156	1,464	1,984	2,784	2,281	1,664
Public Corporations		831	1,099	752	779	1,551	2,944	2,411
	Total	△742	314	1,711	2,585	4,857	7,858	8,329
PSBR	Government	△670	637	1,596	2,321	3,491	8,736	6,786
	Local Authorities	1,238	1,411	1,387	2,362	3,379	2,811	1,586
	(frome Government)	722	739	875	1,017	1,259	1,165	481
	Public Corporations	972	1,205	1,077	1,259	1,470	2,681	3,416
	(frome Government)	836	1,143	1,007	741	744	2,165	1,619
	Net total	△ 18	1,371	2,038	4,168	6,336	10,515	9,512
Its borrowing from	over seas	△1,353	△2,760	1,564	△108	1,490	694	2,667
	Banking	913	1,666	△1,026	1,995	701	3,408	271
	Other financial institutions.	615	1,417	617	1,054	1,921	4,187	6,574
	Private sector.	150	232	209	1,227	2,378	2,222	
	Others.	△43	△20	△6	—	△15.4	4	

(CSO. FS)

Table V. economic analysis of public expenditure

£ million each end of the year

	1970	1971	1972	1973	1974	1975	1976
GDP at factor cost	43,368	49,151	54,958	63,492	73,652	93,078	109,080
Expenditure on good and service	8,692	9,903	11,276	12,753	15,981	22,094	25,742
Its perccentage of GDP	20.1%	20.2%	20.1%	20.0%	21.6%	23.6%	23.8%
Fixed capital formation	2,431	2,562	2,731	3,660	4,410	5,030	5,382
Its percentage of GDP	5.5%	5.1%	4.9%	5.6%	5.9%	5.3%	4.9%
Increase in value of stock	43	51	27	34	32	37	39
Total visible expenditure	11,166	12,516	14,034	16,447	20,423	27,161	31,163
Its percentage of GDP	25.6%	25.4%	25.5%	25.4%	27.7%	29.0%	28.4%
Subsidies	876	931	1,144	1,471	2,987	3,827	3,463
Grants	4,334	4,783	5,844	6,421	7,864	10,201	12,832
Lending to private sector	102	114	162	478	950	383	224
Lending to public carporation	861	1,145	1,079	741	744	2,165	1,619
Lending to overseas sector	93	112	264	396	676	652	711
Cash expenditure on company securities	2	82	36	7	20	557	25
Debt interest	2,026	2,089	2,307	2,760	3,570	4,231	5,446
Others	501	569	663	932	1,027	1,276	1,925
Financial payments	9,542	10,683	12,220	14,053	18,765	24,249	27,343
Its percentage of GDP	20.9%	21.8%	22.2%	22.0%	25.0%	26.0%	25.5%
Totale expenditure	20,701	23,199	26,254	30,500	39,188	51,410	58,506
Its percentage of GDP	47.8%	47.0%	47.7%	48.0%	53.2%	54.8%	53.2%

(C.S.O. Abstract)

Table VI. Money supply and DCE. their factor analysis

£ million each end of the year

	1970	1971	1972	1973	1974	1975	1976
M1	830	1,055	1,517	653	1,437	2,015	1,986
M3	1,586	2,366	5,299	7,232	4,221	2,911	4,614
UK residents' deposits	1,265	2,093	4,804	6,927	3,512	1,717	3,311
Bank lending to public sector	913	1,666	△1,026	1,995	701	3,383	△284
Bank lending to private sector	1,315	1,856	6,434	6,828	4,671	190	3,522
Non residents' deposits	753	1,061	△48	1,411	1,178	1,002	△310
Non deposit liabilities	210	368	652	485	682	834	866
Private holding of public debt	102	2,104	1,007	2,094	3,519	3,559	6,062
Private holding of cash money	312	273	496	305	709	814	811
External financing of the public sector	△1,313	△2,670	1,564	△213	1,435	726	2,662
Bank lending in stering to non residents	25	296	136	189	289	△65	650
Bank lending in forein currency to residents	180	280	725	595	270	210	–
DCE	1,081	1,141	6,878	8,509	7,535	4,838	7,494
PSBR	23	1,373	2,040	4,181	6,364	10,482	9,493

(CSO FS)

Table VII. Distribution of government securities

£ million, each year

		1970	1971	1972	1973	1974	1975	1976	1977
TB	Government departments	3,118	2,336	2,265	1,679	4,444	4,859	6,021	7,566
	Other public sector	–	–	–	–	–	–	–	–
	Banking sector	311	435	561	562	404	841	2,719	2,201
	Other financial Institutions	4	4	4	16	11	44	346	227
	Non residents	1,065	453	702	799	616	1,729	1,210	816
	Personal sector	63	63	54	37	34	51	553	393
	Total	4,651	3,291	3,586	3,093	5,509	7,522	10,849	11,203
	Market holding	1,443	955	1,321	1,414	1,065	2,663	4,827	3,637
Gilt-edged securities	Government departments	4,984	5,918	5,784	7,676	6,388	6,871	6,432	5,246
	Other public sector	191	174	168	171	145	52	54	59
	Banking sector	2,110	2,171	3,013	2,037	2,048	1,996	2,371	2,711
	Other financial Insititutions	5,809	6,584	7,792	8,046	8,756	10,434	13,717	16,042
	Non residents	2,332	2,540	2,698	2,920	3,033	3,099	3,054	2,521
	Personal sector	5,284	5,680	5,887	6,219	7,286	8,273	9,952	9,710
	Total	21,240	23,067	25,342	27,069	27,656	30,725	35,580	36,289
	Market holding	16,256	17,149	19,558	19,393	21,218	23,854	29,148	31,043
	Total market holding	17,699	18,104	20,879	20,807	22,333	26,517	33,975	34,680

(BOE, Q. B.)

Table VIII. Financial accounts and capital issue

£ million quaritery

	financial sarplus and deficit					capital issue		
	public sector	financial institutions	companys' sector	private's sector	over seas sector	gilt edged securities	equities	stocks
1975 I	△ 1,864	△ 835	△ 205	2,305	672	2,329	60	33
II	△ 1,717	△ 23	△ 183	1,785	354	534	511	140
III	△ 2,299	△ 112	△ 481	2,110	583	1,036	340	54
IV	△ 1,978	△ 53	75	1,278	92	1,807	413	1
1976 I	△ 2,265	△ 1,153	378	2,679	201	1,012	336	31
II	△ 1,842	△ 38	△ 218	2,116	395	1,512	469	62
III	△ 2,720	8	△ 857	2,649	386	272	182	△ 12
IV	△ 1,502	105	△ 405	678	423	3,131	98	△ 54

(C.S.O. FS)

Table IX. DCE and M3 in sterling

£ million quartery

	PSBR	private holding of public debt	bank lending to private sector	bank lending to over seas sector	DCE	external official financing	non deposit liabilities	incaease of M_3	out standing of M_3
1972	2,040	1,006	5,510	136	6,686	1,101	652	4,927	25,443
1973	4,164	2,291	5,972	189	8,034	847	485	6,702	32,046
1974	6,333	3,162	3,435	289	6,895	2,958	682	3,255	35,300
1975	10,859	5,595	△ 384	△ 65	4,455	1,375	760	2,330	37,595
1976	9,430	6,089	3,413	650	7,406	2,970	866	3,570	41,165
1975 I	2,378	1,732	370	△ 124	892	215	143	534	34,903
II	2,897	784	△ 213	148	2,048	1,131	245	672	35,824
III	2,554	1,094	△ 481	2	981	△ 249	115	1,115	36,832
IV	2,670	1,985	△ 60	△ 91	834	268	257	9	37,595
1976 I	2,435	1,461	130	345	1,449	668	205	576	37,321
II	2,815	1,335	950	265	2,695	1,344	190	1,161	38,715
III	2,441	782	942	202	2,803	794	349	1,660	40,224
IV	1,739	2,509	1,201	162	269	164	122	△ 17	41,165

on the monetary statistics revised at 1977.

Table X. Financial analysis of PSBR

£ million, each year .

		Cash	TB	Gilt-edged securities	National saving	Net indebtness to the Banks	Debt of Local authorities	Debt of public corporations	External debt	Deficit finance
1972		578	463	515	459	443	443	146	108	1,612
73		544	318	1,556	102	1,027	1,228	755	436	2,585
74	I	262	335	317	9	78	405	76	24	788
	II	233	477	548	18	520	777	11	161	635
	III	214	527	225	2	53	450	119	212	1,633
	IV	603	873	397	8	304	542	70	724	1,801
	total	788	1,542	693	17	241	2,174	276	326	4,857
75	I	129	280	1,824	136	381	369	45	209	1,864
	II	161	910	403	105	107	619	34	346	1,717
	III	132	1,055	829	120	138	41	2	141	2,299
	IV	509	138	2,157	62	33	246	205	142	1,978
	total	673	1,547	5,213	423	103	1,275	124	839	7,858
76	I	183	339	768	213	14	138	253	345	2,265
	II	308	465	859	135	209	39	27	746	1,842
	III	137	279	592	148	104	192	139	25	2,720
	IV	575	1,503	3,180	96	85	41	379	595	1,052
	total	837	1,350	5,399	592	412	410	292	1,711	8,321

(CSD. F. S.)